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¶1. (SBU) Summary: Joint venture securities firms in China only succeed when the foreign partner has explicit management control and can avoid cultural and managerial conflicts, according to managers at two such joint ventures. Chinese security firms, fearing their inability to compete, have asked the China Securities Regulatory Commission (CSRC) to limit foreign securities firms in China. The State Administration of Foreign Exchange has delayed an increase in QFII quotas to reduce foreign exchange inflows and will probably wait on increased QDII outflows to balance larger QFII quotas. Recent gains in the equity markets have been fueled by savings disintermediation, but market fundamentals are sound and the bull market could last as much as five years. The Ministry of Labor and Social Security welcomes foreign involvement in enterprise annuities, but poor tax incentives, strict controls on how the funds are invested and high fixed costs mean that these are unlikely to be profitable. End summary.

¶2. (SBU) Visiting Treasury DAS Mark Sobel and Embassy Finance Minister Counselor David Loevinger met with Fortis-Haitong Investment Management Company CEO and Board Director Tian Rencan on September 17 and Guotai Jun'an Securities Company Deputy General Manager Tuo Qibin on September 18 in Shanghai. (Note: Reftel reports other meetings made by the delegation. End note.)

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JV's Fail When Partners Don't Focus on Strengths
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¶3. (SBU) Fortis-Haitong's Tian attributed the success of his company to the hands-off approach taken by the Chinese partner in the day-to-day running of the fund. In the formation of their joint venture (JV), Fortis made sure that it had the power

to appoint the CEO, CMO and CIO. Haitong has control over the appointment of the Chairman and the CFO. Tian said this was intended to assure them that Fortis would not misappropriate funds. This structure allows each JV partner to focus on its relative strengths, Fortis on asset management and Haitong on local marketing and distribution.

¶4. (SBU) Tian contrasted Fortis-Haitong's "successful" approach with other, less successful, JV fund management companies. He said that "most failures occur when the different management and investment styles and objectives of the Chinese partner-nominated Chairman conflict with those of the foreign-partner-nominated General Manager." These conflicts stem from differing risk management strategies and business management techniques between the two sides. Cultural differences also play a role in failed JVs, especially when the Chinese partners intervene in the decision-making process, said Tian.

¶5. (SBU) In a separate meeting, Guotai Jun'an Securities Firm Deputy General Manager Tuo Qibin largely agreed with Fortis-Haitong's Tian. Tuo admitted that the JV fund management company established by Allianz and Guotai Jun'an has been experiencing problems and that its performance is below the partners' expectation. He blamed "Allianz's stubborn German working style," for the problems since they have not adapted to working "in the Chinese environment."

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Local Opposition to Opening the Securities Industry
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¶6. (SBU) Guotai Jun'an's Tuo said that Chinese securities firms' opposition to foreign investment in the securities sector stems from the belief that local securities companies have no comparative advantage that would allow them to compete. Should they be allowed to operate, foreign firms would quickly hire the limited supply of qualified staff. This would be a significant problem since the local securities firms' compensation packages,

and thus their ability to retain staff, are constrained by the fact that they are state-owned enterprises, he said. Tuo said this view was made clear to the China Securities Regulation Committee (CSRC) at a meeting held in the second half of 2006. At this meeting, local securities companies expressed their concerns about the threats that foreign firms represented and asked the CSRC for protection.

¶7. (SBU) Fortis-Haitong's Tian separately expressed his agreement that the major obstacle to increased foreign investment in China's securities industry comes from the local securities industry. Only after local companies become stronger, better managed and more competitive with foreign companies would the regulators fully open China's securities market to foreign investments.

Enterprise Annuities Developments

¶8. (SBU) According to Fortis-Haitong's Tian, the Ministry of Labor and Social Security (MOLSS) is open to foreign involvement in enterprise annuities. However, both a lack of tax incentives and the 25 percent ceiling on equity allocations make the products unattractive to both businesses and employees. As a result, of the nine companies with enterprise annuities licenses, half have no business. While Fortis-Haitong has signed deals with 25 companies, totaling over RMB 1 billion (USD 133 million) in assets under management, high fixed costs mean that it has yet to be profitable. Concerns about insufficient profitability among existing licensees has made MOLSS reluctant to issue new licenses and has threatened to de-license firms that are not using licenses they have been issued.

¶9. (SBU) Nevertheless, the Chinese Government is pushing the

expansion of enterprise annuities and Tian expects significant growth in this area of the market. According to Tian, the State-Owned Assets Supervision and Administration Commission (SASAC) has issued a circular to large SOEs requiring them to submit draft annuities schemes by June 2008. CSRC has also created a list of companies approved to manage assets.

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QFII Quota Increase Delayed -- Huge Demand for QDII
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¶10. (SBU) Fortis-Haitong's Tian said that the CSRC had been ready to increase the Qualified Foreign Institutional Investor (QFII) quota from USD 10 billion to USD 30 billion. However, over-liquidity in the capital markets led the regulators, especially the State Administration of Foreign Exchange (SAFE), to delay this increase until there were more capital outflows through the Qualified Domestic Institutional Investor (QDII) programs to set off the capital inflows from increasing the QFII quotas. Tian also noted that due to volatility in the equity market, several QFIIs had sold off part of their holdings in an attempt to short the market. Additionally, the CSRC cited this as a justification for delaying the QFII quota increase by saying that there was no need to increase the QFII quota until the original quota has been fully utilized.

¶11. (SBU) Tian said that the QFII requirement that investments be held for minimum periods make them difficult to use in some markets, such as Japan, which requires mutual funds to be redeemable daily. Moreover, given SAFE's desire to promote capital outflows, Tian saw little justification in requiring QFIIs to hold their investments for minimum periods. Still, Fortis-Haitong is interested in expanding the QFII program to include alternative investment such as private equity.

¶12. (SBU) Tian said that there is a huge demand by Chinese investors for QDII products. While investors had been focused on the huge gains in China's equity markets, they were beginning to seek ways to diversify their portfolios. Fortis-Haitong is in the process of designing a QDII product that included Chinese companies listed overseas. Tian attributed the success and massive oversubscription of Southern Fund Management Company's QDII product, issued in September, to the fact that there had

been a dearth of new mutual funds issuances.

¶13. (U) Embassy Finatt has cleared on this cable.
JARRETT